

**Banking, Insurance, Life Insurance and Superannuation (prudential standard)
determination No. 1 of 2019**

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

Banking Act 1959, section 11AF

Insurance Act 1973, section 32

Life Insurance Act 1995, section 230A

Superannuation Industry (Supervision) Act 1993, section 34C

APRA may, in writing, determine a prudential standard that applies to an APRA-regulated institution under:

- (1) subsection 11AF(1) of the *Banking Act 1959* (Banking Act), in relation to authorised deposit-taking institutions (ADIs) and authorised non-operating holding companies (authorised banking NOHCs);
- (2) subsection 32(1) of the *Insurance Act 1973* (Insurance Act), in relation to general insurers and authorised non-operating holding companies (authorised insurance NOHCs);
- (3) subsection 230A(1) of the *Life Insurance Act 1995* (Life Insurance Act), in relation to life companies (including friendly societies) and registered non-operating holding companies (registered life NOHCs); and
- (4) subsection 34(C) of the *Superannuation Industry (Supervision) Act 1993* (SIS Act), in relation to Registered Superannuation Entity Licensees (RSELs).

On 22 November 2019, APRA made Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2019 (the instrument) which revokes *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* made under Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2017 and determines a new *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226).

The instrument commences on upon registration on the Federal Register of Legislation.

1. Background

APRA's mandate is to ensure the safety and soundness of prudentially regulated financial institutions so that they can meet their financial promises to depositors, policyholders and fund members within a stable, efficient and competitive financial system.

In 2015, the BCBS and IOSCO finalised minimum standards for margin requirements for non-centrally cleared derivatives transactions ('the BCBS-IOSCO framework'). Of relevance to the revised CPS 226 is that the BCBS-IOSCO framework requires the exchange of initial margin. Initial margin protects against the potential future exposure that may arise from future changes in the mark-to-markets value of a non-

centrally cleared derivative during the period of time that is assumed to be required to close-out and replace the position following a counterparty default. In December 2016, APRA implemented margin requirements for non-centrally cleared derivatives based on the BCBS-IOSCO framework, which commenced in March 2017 and under which the initial margin requirements were subject to a multi-year phase-in timetable.

In March 2019, the BCBS and IOSCO published a statement noting that the BCBS-IOSCO framework does not specify documentation, custodial or operational requirements if the bilateral initial margin does not exceed the initial margin threshold. The threshold represents the point at which covered entities are not required to post and collect initial margin. The statement also clarified that amendments made to legacy derivative contracts solely for the purpose of addressing interest rate benchmark reforms do not require the application of margin requirements under the BCBS-IOSCO framework.

In July 2019, the BCBS and IOSCO agreed to extend the phase-in timetable under the BCBS-IOSCO framework by one year to 1 September 2021. To facilitate this extension, the BCBS and IOSCO also introduced an additional implementation phase commencing 1 September 2020 requiring covered entities with an aggregate average notional amount of non-centrally cleared derivative exceeding EUR 50 billion to comply from this time.

2. Purpose and operation of the instrument

The purpose of the instrument is to revoke the existing CPS 226 and replace it with a new version of CPS 226.

CPS 226 applies to institutions in the banking, general insurance, life insurance and superannuation industries. Under CPS 226, an entity that actively transacts in non-centrally cleared derivatives is required to exchange collateral as appropriate to those transactions to manage the risk of counterparty default, and to have policies and procedures to manage its risks in undertaking that derivatives activity.

The new version of CPS 226 aligns APRA's margin requirements with the amended BCBS-IOSCO framework and the statement made by the BCBS and IOSCO in March 2019. The key changes are to:

- delay the final implementation phase for initial margin requirements by one year from 1 September 2020 to 1 September 2021 and in doing so, increase the qualifying level of aggregate average notion amount (AANA) of non-centrally cleared derivatives applicable from 1 September 2020 from AUD 12 billion to AUD 75 billion, and defer the application of margin requirements to covered entities with an AANA of non-centrally cleared derivatives greater than AUD 12 billion to 1 September 2021;
- clarify that an APRA covered entity is not required to have initial margin documentation, custodial arrangements and operational processes in place for posting and collecting initial margin in cases where the bilateral initial margin amount for a particular trading relationship is less than the AUD 75 million initial margin; and

- clarify that amending contracts for existing derivative transactions solely for the purpose of addressing benchmark reforms and the application of standard trade maintenance processes on grandfathered transactions do not qualify as new derivative transactions and are, therefore, not subject to the margin requirements.

The new version of CPS 226 also makes minor changes to update or remove out-of-date references.

Where CPS 226 refers to an Act, Regulation or prudential standard and Australian Accounting Standard AASB 10 *Consolidated Financial Statements*, this is a reference to the document as it exists from time to time, and which is available on the Federal Register of Legislation at www.legislation.gov.au. CPS 226 also incorporates by reference the BCBS-IOSCO framework as it exists at 23 July 2019 and the IOSCO Risk Mitigation Standards as they exist at 28 January 2015. These documents are available at: BCBS-IOSCO framework: <https://www.bis.org/bcbs/publ/d475.pdf>; and IOSCO Risk Mitigation Standards: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf>.

The prudential standards provide for APRA to exercise various discretions. Decisions made by the APRA exercising those discretions are not subject to merits review. This is because these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

Under the Banking Act, Insurance Act and Life Insurance Act, a breach of a prudential standard is a breach of the enabling legislation, as each enabling Act provides that regulated entities must comply with the standard. Under the SIS Act, it is a condition on all RSE licences that the RSE licensee must comply with the RSE licensee law, which includes prudential standards. However there are no penalties prescribed for breach of the prudential standards under any of these Acts. Instead an entity's breach of the enabling legislation or RSE licence condition is grounds for APRA to make further, substantive decisions under the relevant enabling legislation in relation to the entity. Those decisions are, as the case may be:

- (a) to revoke a licence to carry on banking business (s.9A Banking Act), insurance business (s. 15 Insurance Act) or life insurance business (s.26 Life Insurance Act), or operate an APRA-regulated superannuation fund (s.29G SIS Act); and
- (b) to issue a direction to the regulated entity, including a direction to comply with the whole or part of a prudential standard (s.11CA Banking Act, s.104 Insurance Act, s.230B Life Insurance Act or s.131D SIS Act).

It is only at this stage that an entity is exposed to a penalty: loss of licence or imposition of a penalty if it breaches the direction (50 penalty units each day under s.11CG Banking Act, s.108 Insurance Act and s.230F Life Insurance Act, 100 penalty units each day under s.131DD SIS Act)¹. The subsequent substantive decisions of APRA to impose a direction or revoke a licence are subject to merits review. In nearly

¹ The exception is s.54B of the SIS Act, which provides that breach of a covenant under s.52 or 52A is a civil penalty provision. The covenants include a requirement to comply with prudential standards in relation to specified topics (conflicts, capital requirements for operational risk, Mysuper and choice products). CPS 226 is not a standard in relation to any of these topics.

all cases² the decisions are preceded by a full consultation with the regulated entity to raise any concerns they may have in relation to the decision.

3. Consultation

APRA undertook a consultation on its proposed changes to the margin requirements in August 2019. APRA received a total of eight submissions from ADIs, industry bodies, and other interested parties. All respondents supported the proposals.

Respondents requested additional clarification of what constitutes a genuine amendment to an existing derivative transaction, which are not subject to initial margin requirements under CPS 226. It was also requested that the footnote be broader than specifying that amending contracts for existing derivative transactions solely for the purpose of addressing interest rate benchmark reforms, such as the LIBOR reforms, would not qualify as new derivative transactions. In response to the requests raised in submissions, APRA has made drafting changes further to the extract of CPS 226 that was released for consultation.

4. Regulation Impact Statement

The Office of Best Practice Regulation has advised that a Regulation Impact Statement is not required for this legislative instrument.

5. Statement of compatibility prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment A to this Explanatory Statement.

² The Banking Act, Insurance Act and Life Insurance Act specifically provide that APRA does not need to consult where APRA is satisfied that doing so could result in a delay in revocation that would be contrary to the national interest or the interests of depositors with the body corporate (s9A(4) Banking Act), contrary to the national interest (s.15(4) Insurance Act), or contrary to the public interest (s26(5) Life Insurance Act), respectively. Consultation is not specifically required under the SIS Act.

Attachment A

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

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This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

Overview of the Legislative Instrument

This legislative instrument makes Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2019, which revokes *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* made under Banking, Insurance, Life Insurance and Superannuation (prudential standard) determination No. 1 of 2017, and determines a new *Prudential Standard CPS 226 Margining and risk mitigation for non-centrally cleared derivatives* (CPS 226).

CPS 226 applies to institutions in the banking, general insurance, life insurance and superannuation industries. Under CPS 226, an entity that actively transacts in non-centrally cleared derivatives is required to exchange collateral as appropriate to those transactions to manage the risk of counterparty default, and to have policies and procedures to manage its risks in undertaking that derivatives activity.

Human rights implications

APRA has assessed this Legislative Instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the instrument is compatible with human rights.

Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.